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PUBLIC SERVICE
COMMISSION

Mr. Thomas M. Dorman
Executive Director
Public Service Commission of Kentucky
Post Office Box 615
Frankfort, Kentucky 40602

Re: Case No. 2003-00165

Dear Mr. Dorman:

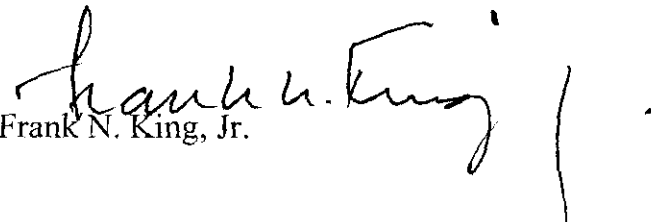
Enclosed for filing in this case please find Brief of Kenergy Corp.

Your assistance in this matter is appreciated.

Very truly yours,

DORSEY, KING, GRAY, NORMENT & HOPGOOD

By


Frank N. King, Jr.

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Copy: Kenergy Corp.
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DEC 23 2003

PUBLIC SERVICE
COMMISSION

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:)
)
THE APPLICATION OF KENERGY CORP.) CASE NO. 2003-00165
FOR REVIEW AND APPROVAL OF)
EXISTING RATES)

BRIEF OF KENERGY CORP.

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Attorneys for Kenergy Corp.

By Frank N. King, Jr.

I hereby certify that this Brief has been served upon the Attorney General of Kentucky, Office of Rate Intervention, 1024 Capital Center Drive, Frankfort, Kentucky 40601, and Michael L. Kurtz, Esq. Boehm, Kurtz & Lowry, 36 East Seventh Street, Suite 2110, Cincinnati, Ohio 45202, counsel for Kentucky Industrial Utility Customers, Inc., by mailing true and correct copies of same on this 22nd day of December, 2003.

Frank N. King, Jr.
Frank N. King, Jr.

May it please the Commission:

Introduction

The threshold issue in this case is whether the existing rates of Kenergy Corp. (“Kenergy”) should be approved. If this question is answered in the affirmative, there are no other issues to be addressed. If this question is answered negatively, then collateral issues arise, namely, whether Kenergy should remain revenue neutral; if so, what customers should receive reductions, at the expense of what other customers; what expenses should be excluded for rate making purposes; and whether Kenergy’s retail service agreement with Weyerhaeuser Company (“Weyerhaeuser”) should, in effect, be amended by the Commission to modify or even exclude the distribution fee on self-generated energy. These issues will be discussed in the order presented above.

1. Should Kenergy’s Existing Rates Be Approved?

In this case Kenergy seeks approval of its existing rates that were established by the Commission just two and a half years ago in its June 29, 2001, order in Case No. 2000-395. Pursuant to 807 KAR 5:001, Section 10, Kenergy’s application is supported by a 12 month historical test year, and not a forecasted test year.

Moreover, Kenergy has not made any forecast for purposes of this case. *Dean Stanley, T/E p. 51, l.14.* The test year is calendar year 2002 and, as permitted, it includes adjustments for known and measurable changes. With such adjustments Kenergy's test year TIER is 1.94 (*Application, Ex. 5, p. 1*), which is slightly below the TIER of 2.00 that the Commission traditionally approves for electric distribution cooperatives. *See, e.g., Case No. 2001-224 involving Fleming-Mason Energy Cooperative Corporation and Case No. 2000-373 involving Jackson Energy Cooperative Corporation.*

Kentucky Industrial Utility Customers, Inc. ("KIUC") contends that its KIUC Members (Alcan, Century, Commonwealth, Kimberly-Clark and Weyerhaeuser) collectively should receive a reduction of approximately \$470,000.00 annually. *Russell L. Klepper Direct Testimony, p. 12, l. 15.* The contention is made that Kenergy can absorb this reduction with the \$2.5 million to be realized upon expiration of its Consolidation Credit Rider on September 1, 2004. *Klepper Direct, p. 13, l. 3.* KIUC's argument is seriously flawed because the 2002 test year is the basis for establishing rates in this case, and not what may or may not occur in 2004, which is entirely speculative at this point. Evidence on the issue of the future on the Consolidation Credit Rider has not been presented in this proceeding and consequently

the issue cannot be briefed. It would be contrary to sound rate making policy to consider the impact of the future of the Consolidation Credit Rider in this proceeding.

Certainly Kenergy's existing rates should not be adjusted just to give the KIUC Members another round of reductions. We say this because these five (5) large industrial customers received in the aggregate a \$252,000.00 annual reduction in Case No. 2000-395, when no other customers received any relief whatsoever. As Kenergy argued in that case, and as it contends now, there are other customers who should receive rate reductions first, if further reductions are to be ordered. This is fully discussed below in section 3.

The contention may be made that Kenergy should have included plans about the future of the Consolidation Credit Rider in this filing. This contention is misplaced because Kenergy needs to analyze revenue and expenses in 2003, rather than a more remote 2002, when deciding how to propose to the Commission the handling of the Consolidation Credit Rider. Year 2003 clearly will be a more reliable harbinger because through September 2003 Kenergy's TIER is down to approximately 1.88. *Steve Thompson, T/E, p. 76, l. 23*. Of course, the Commission's order in the instant case will ultimately dictate the necessary actions in the future with respect to the Consolidation Credit Rider. *Stanley, T/E, p. 34, l. 10*. However, as Kenergy has

reminded the Commission many times, approval of consolidation in 1999 was premised in large part on the commitment to have the Consolidation Credit Rider in effect for five (5) years, and Kenergy earnestly desires to be allowed to honor that commitment. *Application, Ex. 6, Stanley Direct, p. 3, l. 12.*

The contention may also be made that when expenses that should not be considered for rate making purposes are eliminated, there can be an across-the-board reduction in rates and Kenergy can still maintain a 2.00 TIER. Kenergy responds to this generally by stating that perhaps the Commission has encountered problems in the past with other cooperatives that have attempted to cross the line regarding inclusion of questionable expenses for rate making purposes, but this simply is not true in Kenergy's case. As supported by the record, and as the Commission should take administrative notice, Kenergy's board and management endeavor to run a quality operation in a highly professional manner. The expenses it has incurred are valid, reasonable and necessary for the scope of its operations. The issue of what expenses should be excluded for rate making purposes is discussed more specifically below in section 4.

The Attorney General ("AG") has weighed in strongly in support of approval of existing rates at this time. *David H. Brown Kinloch Rebuttal Testimony, p.*

4, l. 2 and p. 12, l. 13. Indeed, the AG's witness Mr. Brown Kinloch asserts that, if anything, the KIUC Members should receive a rate increase because they are "not carrying their weight." *Brown Kinloch Rebuttal*, p. 10, l. 13. Kenergy does not propose such increase, but instead requests approval of existing rates.

2. If Rates Are Adjusted Should Kenergy Remain Revenue Neutral?

There really should not be any issue here, but out of precaution Kenergy addresses the matter. Kenergy's adjusted test year TIER is 1.94, just a shade under the Commission's traditionally approved level of 2.00. There is no contradiction in the record to the position espoused by Kenergy's President and CEO Dean Stanley that Kenergy needs a TIER of this level "to provide financial strength and stability necessary for sound, efficient operations." *Stanley Rebuttal*, p. 3, l. 9.

The Commission traditionally approves a TIER of 2.00 for electric distribution cooperatives and, if Kenergy's rates are adjusted, Kenergy should remain substantially revenue neutral, thereby assuring continuation of a TIER of approximately 2.00.

3. If Existing Rates Are Adjusted And Kenergy Remains
Revenue Neutral, What Customers Should Get A Reduction,
And What Other Customers An Increase?

Initially Kenergy will again briefly address KIUC's argument for a reduction in rates to KIUC Members. In addition to the reasons set forth above in section 1 (looking to 2004 is speculative and contrary to established rate making policy and these customers were the only ones to get a reduction in Case No. 2000-395 when other customers are more deserving) there is a flagrant inconsistency in KIUC's position in this case. On the one hand KIUC rather sanctimoniously takes the position that cost of service considerations trump everything else and control exclusively in setting rates. *Klepper Direct*, p. 7, l. 14 through p. 8, l. 18. However, KIUC also urges the Commission, in effect, to look the other way and consider "economic development, job creation and those type(s) of issues when . . . designing rates" for the large industrial customers. *Stanley T/E* p. 15, l. 15. It should be clear to the Commission that KIUC does not have a credible position in insisting on adherence to strict cost-of-service principles in seeking rate reduction to its members in this case.

KIUC's argument that the rates for KIUC Members should not include an increment for margins is simply untenable. Kenergy believes the Commission should not delve into the allocation and retirement of capital credits in

connection with setting rates, and this is particularly true in this case because the record shows conclusively that Kenergy, being a 501(c)12 nonprofit corporation properly allocates and retires capital credits. Indeed, between January 2000 and June 2003 “capital credit distributions to KIUC Members totaling approximately \$660,000 have been paid.” *Stanley, T/E, p. 2, l. 7.*

Further, KIUC’s complaint about Kenergy retaining approximately \$7 million in the allocated capital credits of the KIUC Members is unsound because this retention represents only 14% of the total \$52 million in capital credits (both figures approximate) being held by Kenergy (*Stanley, T/E p. 54, l. 10*), whereas the KIUC members consume approximately 85% of the energy sold by Kenergy. *Brown Kenloch Rebuttal, p. 8, l. 8.* It is to be pointed out that Kenergy’s equity to total capital ratio is 35.16% (*Response to Commission Staff’s First Data Request, Item 6*) which is squarely within the 30% to 40% range set forth in its Capital Management Policy. *Response to KIUC Second Data Request, Item 7, p. 7 of 11.* Kenergy’s bylaws properly reflect that “the corporation’s operations shall be so conducted that all patrons . . . will through their patronage furnish capital for the corporation” (*Response to Commission Staff’s First Data Request, Item 14, p. 23 of 31*) and Kenergy operates in accordance therewith.

Before leaving the topic of rate reductions for the KIUC Members Kenergy does remind the Commission that it is exposed to considerable financial risk in serving these large industrial customers. Obviously this risk cannot be quantified with exactitude but nevertheless it is always present. Examples of the risk maturing into reality are Kenergy's recent experiences in the Dynegy litigation (U.S. District Court, Western District of Kentucky, Civil Action No. 4:02 CV-220-M) and with Lodestar's bankruptcy (United States Bankruptcy Court, Eastern District of Kentucky, Case Nos. 01-50969, 01-50972 and 03-70015). *Stanley T/E p. 52, l. 3.* Kenergy and Alcan jointly sued Dynegy alleging breach, default and termination of a wholesale power contract. Dynegy responded with a counterclaim demanding compensatory damages in a sum "in excess of \$14 million" and unspecified punitive damages. (At the hearing there was uncertainty regarding the exact amount of the counterclaim and whether punitive damages were being demanded; a review of the counterclaim reveals the foregoing.) Kenergy has indemnity and hold harmless covenants from Alcan, but nevertheless the risk remains. And in the case of Lodestar Kenergy took all reasonable steps to eliminate financial risk but Lodestar went into Chapter 7 bankruptcy owing Kenergy a pre-petition debt of approximately \$165,000.00 and because the bond surety, Frontier Insurance Company, is now insolvent and in rehabilitation, Kenergy's

probability of recovering the Lodestar debt is practically nonexistent. The point here is that if there is any consideration given to the reduction of rates for the KIUC Members, the risk factor certainly is another element for the Commission to consider.

Kenergy's cost of service study (*Application, Ex. 14*) was accepted by both KIUC (with only a de minimus exception that is not relevant here; see *Klepper Direct, p. 8, l. 20*) and the AG (*Brown Kinloch Rebuttal, pp. 7 & 8, response to q. 11*).

Kenergy's cost of service study reflects that what it refers to as "commercial customers" (the nonresidential, nondirect serve customers) have the highest percentage when comparing margins to total revenue (*Stanley Rebuttal, p. 5, q. 5*) so based strictly on cost of service considerations these customers deserve to be at the front of the line if rates are reduced. The AG takes it a step farther and observes that the entire Regular Tariff and Class C should get first rate relief. *Brown Kinloch, p. 6, response to q. 9*. Kenergy's point is that customers other than the KIUC Members should get rate relief first, if adjustments are ordered.

In Case No. 2000-395 the Commission recognized that revenue stability, rate continuity and gradualism are intrigal to rate making. If there are to be any rate adjustments Kenergy respectfully requests that these noncost factors, along with the very significant risk factor, be guiding principles.

4. If Rates Are Adjusted What Expenses Should Be Excluded For Rate Making Purposes?

In the Commission Staff's Data Requests and questions asked at the hearing a considerable number of inquiries were directed at whether specified expenses should be excluded for rate making purposes. These areas of expenses include advertising, charitable contributions, directors' compensation and economic development. Kenergy has acknowledged that expenses for institutional advertising and charitable contributions should be excluded. *Response to Commission Staff's Third Data Request, Item 13 and Response to Commission Staff's First Data Request, Item 30.* Kenergy trusts that with respect to the other expenses in question the Commission will agree that it has responded very forthrightly.

Kenergy certainly has nothing to conceal and submits that its other expenses have been incurred reasonably and prudently and should be included for rate making purposes. The Commission is reminded that Kenergy has over 50,000 member-customers, realizes revenue in the range of \$280 million per year and owns net plant of approximately \$140 million, yet Kenergy's director related expenses compare favorably and blend with similar expenses of the other Kentucky distribution

cooperatives whose operations are of lesser scope. *See Kenergy's Response and Supplemental Response to Commission's Data Request of November 12, 2003.*

Kenergy cannot operate in a vacuum. Kenergy must be proactive and have flexibility to serve existing customers reliably and attract new ones. Kenergy must at all times strive to have a positive image with its members and in the communities of the territory it serves. Kenergy trusts that with the submission of the responses to the data requests propounded at the hearing regarding economic development, it has satisfied the Commission that expenses in this area are valid and legitimate.

Kenergy submits that the standard for including an expense for rate making purpose should be (i) whether the expense benefits the member-customers and (ii) whether the expense is reasonable. *See 64 AmJur2d, Public Utilities, Section 118.* If this standard is applied the expenses incurred by Kenergy during the test year, except for institutional advertising and charitable contributions, will be included for rate making purposes in this case.

5. Should the Commission, In Effect, Amend
Kenergy's Service Agreement With Weyerhaeuser To Modify or Even
Exclude the Distribution Fee on Self-Generated Energy?

Kenergy submits that the emphatic answer to the above inquiry is “no.” Section 37 of the agreement is unambiguous when it clearly states that “Willamette (now Weyerhaeuser) agrees that it shall not assert, as a basis for reducing the amount of the Distribution Fee, the fact that the Distribution Fee is imposed on self-generated power in addition to purchased power . . .” *Section 37 is attached as Ex.. 2 to Klepper Direct.* This section goes on to say that Weyerhaeuser may always assert that the Distribution Fee is excessive in relation to Kenergy’s actual cost of service, which it did successfully in Case No. 2000-395 and which it is attempting to do in this case.

Kenergy’s Mr. Stanley explained very specifically both in his rebuttal testimony and in response to cross examination at the hearing about how the agreement was negotiated over several years, was agreed to at arm’s length, and was voluntarily executed. *Stanley Rebuttal, pp. 5—7, qq. 8—10; T/E pp. 66—68.* As pointed out by Mr. Stanley, the use of the kWh self-generated by Weyerhaeuser was just an administrative vehicle to obtain the negotiated result of keeping Kenergy’s overall revenue at the level before self-generation. To “cherry pick” this one item from

the overall negotiated deal would be a direct violation of the 10 year contract provisions. *Stanley Rebuttal*, p. 6, response to q. 8.

The Commission should take notice that no Weyerhaeuser official has stepped forward to take issue with any statement made by Mr. Stanley with respect to this matter. All of the elements are present for a binding, enforceable contract. *See, generally, cases annotated in 5A Ky.Dig.2d, Contracts*. This agreement was accepted by the Commission as a special contract on May 9, 2001, and should be honored and upheld in its entirety by the Commission in this proceeding.

Conclusion

Kenergy respectfully requests that its existing rates be approved by the Commission but if there are to be adjustments, Kenergy should be allowed to remain substantially revenue neutral and the “commercial customers” should receive rate relief first. Other than expenses for institutional advertising and charitable contributions, Kenergy submits that the expenses it incurred during the test year were for the benefit of its member customers, were reasonable and should be included for rate making purposes if adjustments are to be made. Finally, on the Weyerhaeuser issue Kenergy submits that the agreement should be enforced according to its terms.

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